

## First Supplement to Memorandum 91-32

Subject: Study F-3050/L-3050 - Donative Transfers of Community Property  
(Policy Issues—Comments on Staff Recommendations)

Memorandum 91-32 is a synopsis of policy issues raised in Professor Kasner's study of nonprobate transfers of community property, along with staff recommendations for resolution of the policy issues. We have received letters commenting on the memorandum and staff recommendations from the Los Angeles County Bar Association's Probate and Trust Law Section Executive Committee (Exhibit 1), the Beverly Hills Bar Association's Probate, Trust & Estate Planning Section Legislative Committee (Exhibit 2), and Professor Kasner (Exhibit 3). This supplementary memorandum summarizes their letters.

General Observations

Except as noted below, Professor Kasner believes the memorandum clearly defines the issues and presents a good basis for legislative action. He agrees with the priorities for Commission consideration set out in the memorandum.

The Los Angeles County group has discussed the issues with various attorneys, including estate planners, representatives of banks and other fiduciaries, a member of the Executive Committee of the Family Law Section, and a tax specialist. They observe that there is no unanimity with regard to the policy issues; generally speaking, family law practitioners would like to see stricter rules, whereas the probate bar would prefer more liberalization and codification. Given the divergence in opinions, the Los Angeles County group can only suggest that we proceed with preparation of a tentative recommendation that can be circulated to a wider audience for comment.

The Beverly Hills committee generally favors the policy recommendations set out in the memorandum. They do, however, recommend that the Commission retain a federal retirement benefits expert with a strong background in ERISA law and federal preemption, because of

potential conflict with and preemption by federal laws. They also note the pending California Supreme Court case of Droeger v. Friedman, Sloan & Ross, which addresses the issue whether a spouse may unilaterally encumber up to one-half the community property.

Form of Consent to Donative Transfer

There is general agreement among the Los Angeles County group with the proposal that the law make clear that donative transfers of community property are governed by gift limitations rather than transmutation limitations. Professor Kasner also agrees that this approach is correct, and with the staff recommendation that the existing gift statute be improved by allowing certain gifts with unwritten consent.

The Beverly Hills committee suggests that where a donative transfer of community property is being made to a person other than the surviving spouse, it could be accompanied by a consent form, something along the following lines:

CONSENT TO COMMUNITY PROPERTY TRANSFER

**IMPORTANT NOTICE** to spouse signing this consent form: *You may be giving up substantial property rights by signing this consent form. You may wish to discuss with an attorney the transfer you are consenting to.*

*If you consent to the transfer of community property, initial one of the following choices and sign and date this consent:*

\_\_\_\_\_ I consent to the transfer but do not waive any of my rights in the community property, including the right to revoke my consent at any time before the transfer is complete.

\_\_\_\_\_ I consent to the transfer and waive all my rights in the community property, including the right to revoke my consent. I agree that the beneficiary may be changed without my consent or that the transfer may be revoked without my consent, and I have no further rights in the property. The property does not revert to my estate if I die or if the beneficiary dies or the beneficiary is changed.

\_\_\_\_\_ I consent to the transfer of the community property, but retain the right to revoke my consent at any time before I die or my spouse dies. I agree that after I die or my spouse dies my consent is no longer revocable and I have no further rights in the property.

\_\_\_\_\_  
Signed

\_\_\_\_\_  
Dated

Such a form, according to the Beverly Hills committee, "would take care of the problems of informed consent as well as the problems of determining whether the transfer was intended as a revocable gift as to the consenting spouse or as an irrevocable transmutation of community property. It would also clear up how to deal with the problems of the beneficiary dying or if a specific beneficiary has not been designated."

#### Where Donative Transfer is Made Without Consent

The staff recommends that the law be codified that where a donative transfer of community property is made without the consent of the other spouse, this is a violation of the gift statute entitling the other spouse to revoke as to the entire gift during the marriage and as to the spouse's one-half interest at termination of the marriage. The Los Angeles County probate faction approves this approach.

#### Where Donative Transfer is Made With Consent

Where both spouses consent to the donative transfer and one later seeks to revoke it, can the one revoke without consent of the other, and if so, does the revocation extend to the whole gift or only to the spouse's one-half interest? The general feeling of the Los Angeles County group is that either spouse could revoke the gift before death. "However, there are serious problems regarding the obligations of the third party fiduciary in this situation and regarding the difficulty in evaluating the community property interest, since in some instances the interest may not be fifty percent."

Professor Kasner likewise believes that either spouse should be able to revoke consent during the marriage. "While such a liberal revocation power presents many problems, so would a rule that requires the consent of both spouses to revoke." Requiring both spouses to act would be contrary to the terms of some insurance policies, and could have adverse federal gift tax consequences. It would also cause problems in a failing marriage, where joint action by the spouses would be difficult.

### Rights in Property After Death of Donor Spouse

The staff recommendation is that on death of the donor spouse, if the other spouse has consented the gift is irrevocable, and if the other spouse has not consented the gift is revocable as to the other spouse's one-half interest in the community property. The Los Angeles County group was in general agreement that this is proper.

### Rights in Property After Death of Consenting Spouse

The staff suggests five possible approaches to dealing with the right of the donor spouse to revoke a nonprobate transfer of community property after the death of the consenting spouse:

- (1) The donor has full power to revoke.
- (2) The donor may revoke as to the donor's one-half interest; consenting spouse's interest passes under the original beneficiary designation.
- (3) The donor may revoke as to the donor's one-half interest; consenting spouse's interest passes with consenting spouse's estate.
- (4) No revocation allowed.
- (5) Donor may revoke with consent of consenting spouse's legal representative.

Of these approaches, the probate bar faction of the Los Angeles County Bar group prefers either (1) or (2), whereas the family law practitioner faction favors (4). The Beverly Hills committee disagrees with (4) and (5).

Professor Kasner discusses whether there should be special rules in this area for retirement benefits. Problems will arise if the surviving spouse does not have full power to deal with and change the death beneficiary. But this in effect is an extension of the terminable interest rule, terminating the rights of the deceased spouse in what may be the most significant community asset. "Given the incidence of remarriage, if I represented the nonparticipant spouse, I would feel ethically obligated to point out that if he or she consents to a beneficiary designation, and after his or her death the other spouse can change it, it may well end up in the hands of the new spouse rather than the children of the marriage." However, Professor Kasner

also indicates that the nonprobate transfer rights of a deceased nonparticipant spouse are unclear in any event, and he encloses a copy of a short article he has written on this matter.

Special Problems

The staff recommends that work on special nonprobate transfer problems be deferred in order that we can prepare a manageable recommendation for next session. Of these matters, the Beverly Hills committee believes the Commission should address now the issue of the right of a nonemployee spouse to make a donative transfer of the nonemployee spouse's one-half interest in a community property retirement or death benefit plan, since all federal preemption issues should be handled together.

Respectfully submitted,

Nathaniel Sterling  
Assistant Executive Secretary

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May 8, 1991

Nathaniel Sterling  
Assistant Executive Secretary  
California Law Revision Commission  
4000 Middlefield Road, Suite D-2  
Palo Alto, California 94303-4739

Re: Study L-3050 (Donative Transfers of  
Community Property - Policy Issues)

Dear Mr. Sterling:

The Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association has reviewed Memorandum 91-32 and the members of the Law Revision Commission Subcommittee have discussed the policy issues raised therein with various attorneys, including estate planners, representatives of banks and other fiduciaries, a member of the Executive Committee of the Family Law Section and a tax specialist.

It is clear that there is no unanimity with regard to the policy issues raised in Memorandum 91-32. On the one hand, there are those who seek greater specificity of standards for donative transfers and essentially approve the existing transmutation treatment as interpreted by MacDonald. Obviously, this group, which would appear to be composed primarily of family law attorneys, opposes any legislation along the lines proposed by Professor Kasner.

On the other hand, most of the probate bar, like Professor Kasner, would prefer to see some additional flexibility and would like to liberalize and clarify the rules relating to the donative transfer of community property. While there are still substantial areas of disagreement between even those in favor of legislative changes, it is generally correct to say that donative transfers of community property and consent thereto should be governed by the gift statutes rather than the transmutation statute.

This second group also generally supports the codification of existing law where the donative transfer is made without consent.

Where the donative transfer is made with consent, the general feeling is that either spouse (rather than the staff's proposal of both spouses) could revoke prior to death. However, there are serious problems regarding the obligations of the third party

fiduciary in this situation and regarding the difficulty in evaluating the community property interest, since in some instances the interest may not be fifty percent.

The staff's proposals relating to rights after death of the donor are generally supported. Clearly the more difficult case is that of the death of the consenting spouse. Again, the family law practitioner favors the staff's proposal number four, i.e. the beneficiary designation is absolutely locked in by the death of the consenting spouse, while most of the probate bar feel that either the Halbach proposal (number one) or the Kasner proposal (number two) should be adopted.

Given the divergence in opinions, we can only suggest that the staff proceed with preparation of a Tentative Recommendation in light of our comments which can be circulated to a wider audience for additional comment.

Thank you for your consideration of these comments. I expect to attend the June meeting and will be glad to answer any questions that may arise.

Very truly yours,



Carol A. Reichstetter

cc: Members of the Executive Committee

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May 21, 1991

CALIFORNIA LAW REVISION COMMISSION  
4000 Middlefield Road, Suite D-2  
Palo Alto, California 94303-4739

Attention Nathaniel Sterling

Re: Study L-3050 Donative Transfers of Community Property  
Memorandum 91-32

Dear People:

The Legislative Committee of the Probate, Trust & Estate Planning Section of the Beverly Hills Bar Association, has reviewed and discussed the above Memo and approves the staff recommendations supported by the following comments.

Non-probate transfer documents purporting to designate an alternate beneficiary should indicate, perhaps on a separate document that the spouse has a choice as to what rights he or she are giving up. There could be two boxes to check, one that indicates a revocable gift to a particular beneficiary without waiving any community property rights, and one that indicates a transmutation of community property rights by, in essence, giving the participant a specific power of attorney to change beneficiaries without the non-participant's consent, with the understanding that the transfer of interest is irrevocable and shall not revert to the non-participant's estate, should the consenting spouse die or the beneficiary die or be changed at some later point in time.

We also throw out the suggestion of a third box which will permit transmutation of the property only upon the death of the first to die, thereby giving the option of both spouses to revoke the designation and consent until the ability to negotiate a change has been lost by the death of one of the parties.

There could also be included in such documents a notice that the consenting spouse may be giving up substantive rights and should discuss the impending gift or transfer with an attorney. This would take care of the problems of informed consent as well as the problems of determining whether the transfer was

California Law Revision Commission  
May 17, 1991  
Page 2

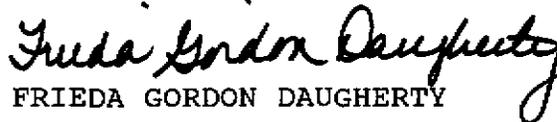
intended as a revocable gift as to the consenting spouse or as a irrevocable transmutation of community property. It would also clear up the how to deal with the problems of the beneficiary dying or if a specific beneficiary has not been designated.

Our committee would also recommend that the Commission employ the services of a Federal retirement benefits expert, someone with a strong background in ERISA law and federal preemption. We believe that if major legislative changes are made to clarify the holding of MacDonald, then there may be serious conflict with and preemption by federal laws.

Finally, our committee wishes to point out that the case of Droeger vs. Friedman, Sloan & Ross is to be heard in oral argument before the California Supreme Court on June 14, 1991. Because the result of that case will highly affect the results of this study, in that the decision will determine whether a spouse has the right under Civil Code §5125 to unilaterally alienate up to one half of the community property or whether such a transfer, without the written consent of the other spouse is void, we suggest that a final recommendation be deferred until after a decision has come down.

Regarding the section on pages 8 and 9 entitled Revocability by surviving donor spouse, we do not agree with the alternatives 4 and 5 on page 9. We do agree to defer the life insurance and gifts in view of impending death issues, but believe the retirement plans and death benefits plans should be addressed concurrently with the rest of the study because of the above-mentioned federal preemption problems.

Very truly yours,

  
FRIEDA GORDON DAUGHERTY

FGD:s

cc: PHYLLIS CARDOZA  
Administrative Vice Chair  
Legislative Committee  
KEN PETRULLIS, ESQ.  
Probate, Trust & Estate Planning Section  
Beverly Hills Bar Association

TO: THE CALIFORNIA LAW REVISION COMMISSION

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FROM: PROFESSOR JERRY A. KASNER

SUBJECT: RESPONSE TO THE APRIL MEETING AND MEMORANDUM 91-32

The purpose of this memo is to respond in writing to Staff Memorandum 91-32 outlining the policy issues raised by Estate of MacDonald, 51 Cal. 3d. 262 (1990).

The Commission has identified as a primary concern the issues raised in MacDonald relating to nonprobate transfers of community property. The Memorandum correctly focuses on the concept that a nonprobate transfer of community property should fall generally under the rules pertaining to gifts of community property, not the transmutation issues which were the focus of MacDonald.

The Staff is also completely correct in its conclusion that present California law is inadequate to deal with such gifts. As my report indicates, prior to MacDonald the decisions in this area, which focused on both life insurance and death benefits, involved situations where one spouse attempted to make a nonprobate transfer of the entire community without the written consent of the other spouse. While often characterizing this as an "inchoate gift", and concluding the other spouse could set it aside as to his or her community interest, they did not involve spousal consent. As the Staff suggests, it may be useful to codify this rule.

On the issue of consents, the Staff and I may have different views on the power of revocation while both spouses are alive. As the Memorandum states, I believe either spouse should have the power to revoke, and that this nonprobate transfer is no different than a revocable living trust, where it is clear the spouses have such a power.

While such a liberal revocation power presents many problems, so would a rule that requires the consent of both spouses to revoke. It would in many cases be contrary to the express provisions of the plan or life insurance policy which permits one spouse to change the beneficiary, which is essentially a revocation, without the consent of the other. The insurance company or plan administrator will in any case insist on paying benefits to the designated beneficiary, and leave it to interested parties to contest this through litigation and the possible use of a constructive trust.

Furthermore, a requirement that both spouses consent to a revocation could have a disastrous federal tax consequence. The effect of such a rule could be to make nonprobate transfers irrevocable; therefore completed gifts for federal gift tax purposes. While it is true that such a gift is incomplete for tax purposes if it can only be revoked with the consent of a non-

adverse party, the other spouse may be an adverse party if he or she has a financial interest in the beneficiary designation. Thus the designation of a trust as beneficiary, where the consenting spouse is a beneficiary of the trust, would probably result in the gift being completed for federal gift tax purposes, resulting in potential gift tax liability. See IRC Reg. Sec. 25.2511-2(e).

Finally, such a requirement of consent to revocation raises difficult issues in the failing marriage or the failed marriage, where neither spouse can effectively sever this joint action without the consent of the other, and joint action in this situation may be impossible. See, for example, Estate of Kahn, 168 C.A.3d 270, where the power to revoke a trust was reserved to the husband and wife, and an attempt by the husband to revoke it was ineffective.

Both Ed Halbach and at least one speaker from the floor raised questions as to whether or not retirement benefits were a special form of community property that should be subject to special rules. As I indicated at the meeting, I share Ed's concern over the difficult problems which will arise if the surviving spouse who is the participant in a qualified retirement plan is not free to change the death beneficiary, given the fact that such plans are viewed primarily as providing for retirement of the participant and spouse while alive, not death benefits after both are gone.

However, I am concerned that giving a surviving plan participant a power to alter the beneficial enjoyment of the plan after the death of the other spouse is really in a sense an extension of the terminable interest rule. Further, retirement plans are now one of the principal assets in the estates of many persons, in fact, often the principal asset. Given the incidence of remarriage, if I represented the nonparticipant spouse, I would feel ethically obligated to point out that if he or she consents to a beneficiary designation, and after his or her death the other spouse can change it, it may well end up in the hands of the new spouse rather than the children of the marriage.

On the other hand, it must be noted that if the nonparticipant spouse does make a probate or nonprobate transfer of a community interest in a retirement plan, assuming federal or state law permits, it is not really clear what will end up passing to the beneficiaries. Nat and John have sent me a copy of an excellent article touching on this subject written by Professor Philip H. Wile of the McGeorge School of Law, which points out the problems this creates. Enclosed is a copy of a short article I have written for the PHINET tax database expanding on some of the points he raises, particularly how difficult it is to value such rights where they are not vested.

In all remaining respects, I believe the Memorandum has clearly defined the issues and is an excellent basis for legislative action. I also completely agree with priorities the

staff has recommended. I look forward to continuing to work with the Staff and Commission on legislative proposals.

Jerry A. Kasner

A RECENT ARTICLE DISCUSSES VALUATION OF A DECEASED  
NONPARTICIPANT SPOUSE'S COMMUNITY INTEREST IN A RETIREMENT PLAN

Professor Philip H. Wile, Professor of Law and Director of Graduate Tax Programs at McGeorge School of Law, University of the Pacific, has recently written an excellent article titled "Federal Estate Taxation of the Nonemployee Spouse's California Community Property Interest in the Surviving Spouse's Qualified Retirement Benefits, published in 22 Pacific Law Journal 825. It raises issues which are vexing to practitioners in all community property state, particularly those dealing with valuation of such interests.

Assuming the nonparticipant spouse who has a community interest in retirement plan benefits is the first to die, and that this is property to be included in his or her gross taxable estate since the repeal of IRC Sec 2039(c) in 1986, how is this right to be valued? Unless retirement benefits under the plan are already vested and payable, or an irrevocable election has been made as to the form of payout, such as a survivor annuity, there is no readily ascertainable method of valuation. This is particularly true where the retirement plan is not fully vested or in whole or in part is subject to forfeiture. The annuity valuation rules would not be appropriate where that form of payout is not fixed. There is no equivalent of a "cash value" as in the case of life insurance, although if a defined contribution plan is involved, it may be easier to use something like cash value or present value for this purpose. Obviously, the willing buyer-willing seller tests will not be applicable.

The practitioner faced with the valuation problem described by Professor Wile may find an answer to this riddle in the cases and ruling dealing with valuation of pensions and retirement benefits for purposes of marital dissolution in the particular community property state in question. In California, practitioners have been faced with this issue since the 1976 state Supreme Court decision in Marriage of Brown, 15 Cal. 3d 838, which held that a nonvested interest in a retirement plan was a divisible community asset on marital dissolution. About the same time, California courts developed what is sometimes called the "time rule" to value pension benefits. Three cases which discuss that rule are In re Marriage of Judd, 68 C.A. 3d 515, 137 Cal. Rptr. 318; In re Marriage of Adams, 64 C.A. 3d 181, 124 Cal. Rptr. 298; and In re Marriage of Poppe, 97 C.A. 3d 1, 158 Cal. Rptr. 500. Basically, the time rule requires allocation of the present value of future retirement benefits based on a fraction, the numerator of which is the length of service of the employee during marriage but before separation, and the denominator is the total length of service. The result is the present value of the community interest in the plan. Note that in California, earnings during separation are separate property. In other community property jurisdictions, the numerator will have to be modified if post-separation earnings are community property.

this formula is admittedly simplistic, but the California courts appear to be happy with it. The biggest shortcoming is the determination of the present value of future benefits, particularly where the plan is not fully vested. In general, and

with the concurrence of valuation experts, this present value is based on first determining the present value of the projected future retirement benefits, then discounting this amount to reflect adjustments for mortality, interest, and vesting.

The discounts for mortality and interest are based on usual actuarial principles, and present no insurmountable problems. However, a discount based on the probability of vesting is much more problematical. Basically, the expert looks to employee turnover and the past history of the company in question as regards vesting of employees in the company retirement plan. The experts focus on the required period of additional employment before vesting, and then the period between vesting date and earliest retirement date. The required period of additional employment before vesting will focus on employee turnover. Once the plan is fully vested, one approach, discussed in In re Marriage of Verlinde, 189 C.A. 3d 918, is to determine what the employee would be entitled to if he or she quit immediately, and what he or she would be entitled to if the employee retired at the earliest possible date. The difference between these two figures is the prorated based on the number of years between these two dates. For other California cases involving actuarial computations over the life expectancy of the employee, see In re marriage of Kasper, 83 C.A.3d 388, and In re Marriage of Bergman, 168 C.A.3d 742.

The time rule is generally inappropriate where defined contribution retirement plans are involved, and a footnote in the court's opinion in In re Marriage of Adams cited above indicates

that the same rule used to apportion interests in life insurance would be appropriate here. What the court was referring to was the California rule that in most cases, community and separate interests in life insurance will be based on the portion of premiums on the policy paid with community funds to the total premiums paid. This could be applied to defined contribution plans by the use of a fraction, the numerator of which is total contributions to the plan during marriage, and the denominator of which is the total contributions to the plan to date of death. Since this fraction would be applied to the total value of the plan interest at date of death, there is of course no adjustment for mortality or interest. However, if there is a risk of forfeiture, the value should be adjusted for that in a manner similar to that discussed above in connection with defined benefit plans.

Even after all this work is done to establish value, it is not clear what really comes out at the end. If the plan benefit is payable to the surviving spouse, or passes in the form of a retirement annuity under the Retirement Equity Act, or otherwise qualifies for the federal estate tax marital deduction, the practitioner has gone to a lot of work and expense to establish a value for the the decedent's interest in the plan which will then be offset by the marital deduction. This was one of the reasons IRC Sec 2039(c) was adopted to begin with. In the case where the decedent's community interest in the plan passes in a form which does not qualify for the marital deduction, as where the spouses have agreed to waive the survivorship rights under the Retirement Equity Act, or the survivor annuity does not apply to the entire

value of the plan interest, the valuation technique will be important not only to establish the federal estate tax value of the plan benefit, but also to determine what portion of the benefits will, when paid, constitute income in respect of a decedent under IRC Sec 691.

If a decision is made to dispose of the decedent's interest in the retirement plan in a form which does not qualify for the federal estate tax marital deduction, there are other consequences to be considered. As Professor Wile points out in his article, the federal estate tax attributable to this particular asset of the decedent cannot be collected from the plan itself, which is subject to anti-assignment provisions under ERISA. Also, the estate beneficiaries who are to receive the decedent's interest in the plan may have to wait years before receiving anything, and if there is a forfeiture, may never receive it at all. Also, it is unclear whether or not the decedent's community interest in the plan will be increased to reflect interest or earnings, although it certainly should be. The actual payout of the benefits may depend entirely on an election made by the surviving spouse at retirement. All in all, this is not a satisfactory set of circumstances.